European Banking Federation

Chief Executive

Ref.: EBF_004146

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Brussels, 16 September 2013

<u>Subject</u>: ***EBF Comment Letter on the EFRAG Bulletin 'The Role of the Business Model in Financial Reporting'***

Dear Ms Flores,

One of the conclusions of the European Banking Federation[1] (EBF) panel discussions of June 2013 highlighted the importance of the reflection of the business model in financial reporting and that more work needs to be done around its articulation. In this context, you have called for the industry to contribute to the work of EFRAG in this area.

You will find enclosed herewith a short paper that articulates our views on the role and importance of the business model. It is the view of the EBF that the business model approach is the most useful way of presenting financial information in a way that is relevant to a particular entity and the environment in which it operates.

We very much appreciate the proactive work of EFRAG and the issuance of its bulletin to stimulate the debate within Europe. In general, we agree with EFRAG's conclusions and would support the efforts of EFRAG to encourage the IASB to include the business model approach in the Conceptal Framework.

We hope you will find our input useful and remain at your disposal if you have any questions or you would wish that we elaborate our views in more details.

Yours sincerely,

Guido Ravoet

[1] Launched in 1960, the European Banking Federation is the voice of the European banking sector from the European Union and the European Free Trade Association countries. The EBF represents the interests of some 4,500 banks, large and small, wholesale and retail, local and cross-border financial institutions. Together, these banks account for over 80% of all bank loans in the EU alone.

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BUSINESS MODEL AS A BASIS FOR ACCOUNTING

Introduction

Financial statements should provide information about the financial position of the entity and the effects of its transactions and other events, so that users can evaluate the prospects for future net cash inflows, and also how management are discharging their responsibilities for the entity's resources.

A properly articulated business model will be helpful in communicating management's understanding of the business to the market. The business model should describe how the entity creates, delivers and captures value, reflecting how the business is managed. For financial services firms the business model will include a broader consideration of the relationship between assets and liabilities, and how these are used to create value. The purpose of this paper is to explore this concept and to articulate the EBF's view of the use of the business model as a basis for accounting.

The concept of a business model and relevance to banks

The fundamental qualitative characteristics in the 2010 Conceptual Framework are relevance and faithful representation and these are enhanced by their relationship to the business model concept. Recognising the business model in standard setting is that it creates financial information that is measured on a basis that is more relevant to how the entity operates in its economic environment and provides a more faithful representation of an entity's financial position and performance.

The business model approach recognises that there are different ways in which a combination of asset and liabilities can be used to create value for shareholders. Since the business model sets out how value is created and delivered to customers, understanding how financial assets and financial liabilities will be used, whether individually or managed together to create and deliver value is critical. Recognising the business model in financial reporting means that an entity's financial statements contain information that reflects the entity's specific circumstances and is more likely to be useful in predicting future cash flows. For example, entering into a contract to receive a commodity creates different expectations of future cash flows for a commodities trader than for an energy provider. Another example would be when an entity holds a property, and the value to the entity would be different depending on whether an entity intended to use the property in its business or to obtain rental income or capital gains.

Clearly if different measurement bases are used by different entities then there could be a reduction in comparability, however there is a difference between comparability and uniformity. If two entities have different business models, then differences can be expected to arise in their future cash flows and reflecting this in the financial reporting should be more useful for investors than a single approach which would be less reflective of these differences.

The business model approach is already utilised in IFRS 9 'Financial Instruments' which takes account of the fact that banks use different portfolios for different purposes. Where a portfolio of instruments is held for trading, then fair value provides the most useful information for investors. Where a portfolio will be held to collect cash flows, fair value is less relevant and amortised cost is more representative of the value to an entity (the usefulness of fair value is explored further in the next section).

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In addition to having strategies for using financial instruments in the business, banking institutions have different strategies for mitigating risks. Financial instruments are complex instruments containing different risks which are often managed in different ways. It is crucial to provide transparency of the results of risk mitigation strategies in the financial statements. While some risk mitigation techniques are focused on reducing volatility in the fair values reflected on the balance sheet, other techniques are focused on ensuring stability of cash flows and income. Hedge accounting is another example of where different measurement rules are permitted in certain circumstances, because this better represents an entity's risk management objectives in the financial reporting.

In summary, using a business model is a way for entities to present financial information to investors in a way that is appropriate to that entity's operating environment, and is an approach already used in several IFRSs, most notably in IFRS 9.

The relevance of fair value

A key issue in representing a different business model is measurement and the appropriateness of the use of fair value. In circumstances where financial instruments are managed on fair value basis, this information alone is sufficient for management to explain the business model and performance of the entity and for users to fully understand the future expected cash flows. Fair value reflects both the business model and the expected future cash flows for financial instruments that are actively traded. However, the current fair value and the change in fair value between reporting periods do not always faithfully represent transactions in financial instruments undertaken or their contribution to sustainable earnings where the business activity is not based around short-term trading or the instruments are not managed on a fair value basis.

Fair value has more predictive value than historical amortised cost for those items held with the aim to earn the return through managing them on a fair value basis. In a business model where the underlying strategy is to draw benefit from short-term variations in the value of the instruments and where the entity is actively engaging in opening and closing market risk positions, it is appropriate for the entity to fair value such instruments. Fair value is also relevant information for the primary financial statements. Investors can rely on such information in order to assess the return on their investments in the entity, as changes in the fair value of instruments managed on a fair value basis can affect dividends paid as well as the value of their investment. For lenders assessing loans granted to businesses with a fair value business model, fair value is representative of the resources that will be available for the entity to pay its debts, as according to the entity's strategy, the fair value of the instruments will be translated in to future cash flows.

The fair value of financial instruments that are not managed on a fair value basis encompasses the market's view of the current value of the expected future cash flows. While this information is important to some users of financial statements, it is not sufficient for an understanding of the transactions undertaken by the business and how they will be reflected in the future cash flows, including both the amount and the timing of such cash flows.

If the instrument is held for use in the business to generate cash flows and there is no current or future intention to sell significant amounts, the aim is to achieve a stable income flow earned on an ongoing basis over a certain period. In this case, material profit from short-term market movements will not arise. The assets are expected to be held for substantially all their lives, and this means that the future cash flows are readily identifiable. Holding a financial instrument to maturity is similar to holding inventory, where it is considered inappropriate to recognize any increase in market value until the item is sold and the revenue is earned (although it is appropriate to recognize impairment).

Information that will assist in understanding the timing of the potential cash flows, credit risk and probability of default will be most relevant and useful for the users of financial statements. Amortised

cost, including any impairment and taking into account the additional details in the notes, provides investors with more relevant information on potential cash-flow performance than fair value alone.

Accordingly, either fair value or amortised cost can provide the most relevant information depending on the circumstances, and so using the business model approach to determine this helps ensure that the primary financial statements are presented on the basis that best reflects the earnings flows that different types of instrument will achieve.

An example of a common business model within a financial institution

A situation where the choice of business model has a significant impact on a bank is that of a typical liquidity portfolio. Such portfolios meet the regulatory requirements for an entity to have sufficient liquidity in terms of stressed scenarios and the need to maintain a sufficient regulatory buffer in times when there is a need for increased liquidity. Such portfolios are also used to support the deposit and lending businesses, seeking to manage the liquidity and interest risks arising from these businesses. Some entities may separately identify portfolios for these different purposes, but others may manage the whole together.

Many jurisdictions have regulatory requirements that instruments in these portfolios must be sold from time to time to demonstrate liquidity to the local regulators (although the nature and amount of sales required by regulators may vary by jurisdiction or portfolio). There is also a need to re-balance these portfolios from time to time due to changes in the underlying deposit and lending businesses and in interest rates and potentially in the credit quality of the investments. There is no intention on behalf of the entity to manage these portfolios in terms of producing short term profits.

There were concerns that under the limited amendments to IFRS 9, that these would fail the amortised cost classification, creating a mismatch in the balance sheet, given that the underlying liabilities are accounted for at amortised cost. This disconnects between the actual business model and the accounting could undermine the quality of financial statements and the ability of financial reporting to explain the results.

Banks manage their business on a portfolio basis, with portfolios being put together to meet the business objectives. A distinction needs to be made between the intention to generate contractual cash flows and the intention to realise profit in the near term. A bank’s assets are financed by its liabilities e.g. deposits. However, since the bank has only limited influence over its liabilities, these are normally subject to fluctuations e.g. customer withdrawals of deposits. Since changes in liabilities necessitate adjustments to the bank’s assets, sales ahead of maturity are sometimes inevitable.

When a standard requires the use of a business model, careful analysis is required to determine which business model most accurately reflects the nature of the business. The liquidity portfolio model is an example of a portfolio where the business model approach should provide financial reporting which is much more specific to an entity, and therefore useful to investors.

Conclusion

It is the view of the EBF that the business model approach is the most useful way of presenting financial information in a way that is relevant to a particular entity and the environment in which it operates. We intend to support EFRAG and to encourage the IASB to include the business model approach in the Conceptual Framework.

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